Offshoring, Relationship-Specificity, and Domestic Production Networks

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Abstract

An economy is an interlinked web of production units. This paper examines both theoretically and empirically how firms' offshoring decisions lead to the reorganization of the domestic production network. We build a buyer-seller model that features supplier heterogeneity in efficiency and distance, as well as intermediate inputs that vary in the degree of specificity to the relationship with the buyer. The model predicts that the more productive buyers will source inputs from a larger range of domestic regions, especially for generic inputs. Inputs that are more relationship-specific are less likely to be sourced from distant regions or foreign countries. A drop in offshoring costs will induce the more productive final good producers to replace some of the closer and less efficient domestic suppliers by foreign suppliers. The resulting increase in productivity will expand the geographic scope of domestic outsourcing. Generic input suppliers are more likely to be dropped, despite their higher productivity. Using unique and exhaustive data on the buyer-seller network in Japan, we find evidence supporting the main predictions of the model.

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